

## Submission of the Center on Budget and Policy Priorities

To the House Ways and Means Committee's Education & Family Benefits Tax Working Group

April 15, 2013

# Low-Income Families and Individuals and Refundable Tax Credits

## Introduction

The Earned Income Tax Credit (EITC) and the Child Tax Credit (CTC) encourage and reward work by parents. New and exciting research finds that these credits also improve the educational performance, future work effort, and health outcomes of children in these families. Below we describe this empirical research and recommend further improvements to the EITC and the Child Tax Credit (CTC). Specifically, we recommend:

- 1) Making permanent the recently extended improvements to the EITC and CTC, such as marriage penalty relief.
- 2) Filling a longstanding gap in the EITC by strengthening the credit for childless workers so that, for example, more single men are pulled into the formal job market and, among other benefits, improve their marriageability.
- 3) Adopting several simplification and compliance measures to reduce errors.

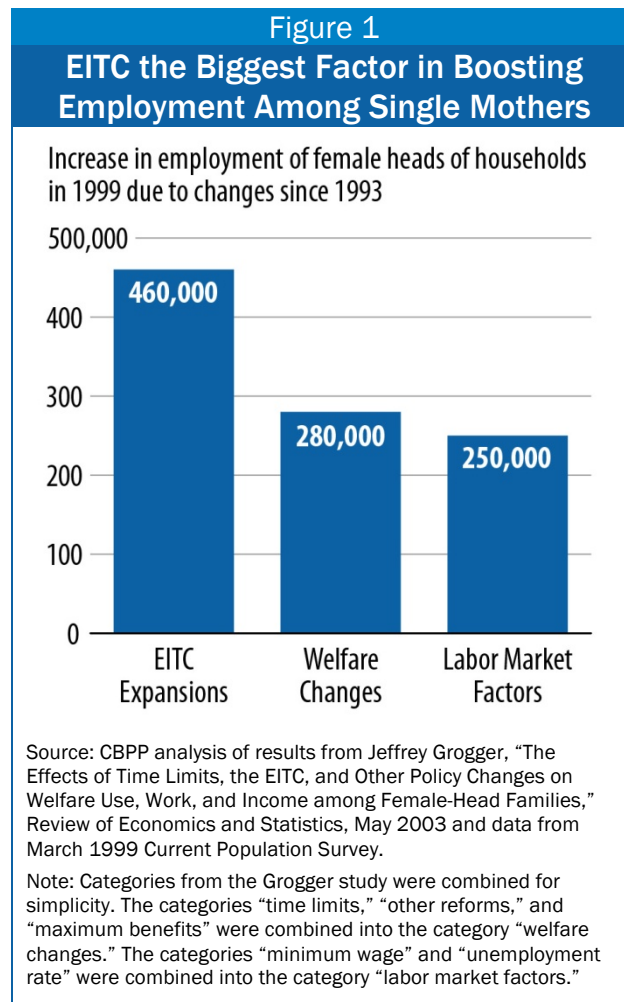
## Research Overview

About 27.5 million working families with low and moderate incomes, most of whom are raising children, received the Earned Income Tax Credit (EITC) in 2010 to reduce their taxes and supplement their earnings.<sup>1</sup> Studies have found that the EITC encourages work and boosts children's achievement in school. Research also suggests that the EITC may improve infant health and that the improved school performance of children whose families receive the EITC translates into increased earnings and work hours when they are adults. The Child Tax Credit (CTC), designed to help offset the cost of raising children, also plays an important role in helping low-income working families. (Because the EITC has been in place for a longer period of time, most of the research is focused on the EITC though the same lessons likely apply to the CTC, which also phases in as earnings increase.)

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<sup>1</sup> In 2010, the most recent year for which data are available, EITC filers with qualifying children received about 97 percent of EITC benefits. The other 3 percent went to poor workers not raising minor children, some of whom can qualify for a small childless workers' EITC. IRS, Statistics of Income Division.

**Encouraging work.** To qualify for the EITC and the low-income component of the CTC, a person must have a job. Numerous studies have found that the EITC promotes work. “[T]he overwhelming finding of the empirical literature is that EITC has been especially successful at encouraging the employment of single parents, especially mothers,” write economists Nada Eissa of Georgetown University and Hilary Hoynes of the University of California, Davis.<sup>2</sup> In fact, while policymakers often point to the 1996 welfare law’s creation of Temporary Assistance for Needy Families (TANF) as a primary reason for increased work among single mothers, the research indicates that the EITC expansion had an even larger effect than the welfare law in producing these gains.<sup>3</sup>



**Improving children’s school performance and health.** A robust set of research — including studies that feature experimental designs and evaluations that use large samples from the general population with a robust set of statistical controls — finds that increasing children’s incomes,

<sup>2</sup> Nada Eissa and Hilary Hoynes, “Behavioral Responses to Taxes: Lessons from the EITC and Labor Supply,” October 10, 2005, [http://www.econ.ucdavis.edu/working\\_papers/05-29.pdf](http://www.econ.ucdavis.edu/working_papers/05-29.pdf).

<sup>3</sup> Jeffrey Grogger, “The Effects of Time Limits, the EITC, and Other Policy Changes on Welfare Use, Work, and Income among Female-Head Families,” *Review of Economics and Statistics*, May 2003.

particularly when they are young, has a positive impact on educational outcomes. In a review of several experimental studies, leading researchers concluded that a credit worth about \$3,000 (in 2005 dollars) to a working parent during a child's early years may boost that child's achievement by the equivalent of about two extra months of schooling.<sup>4</sup> Other researchers analyzed data for grades 3-8 from a large urban school district and the corresponding U.S. tax records for families in the district. Even under conservative assumptions they found that the additional family income from the EITC and CTC leads to significant increases in students' test scores.<sup>5</sup>

In addition, recent studies suggest that the EITC may also include important health outcomes. Recent studies indicate that expectant mothers who receive the EITC are more likely to obtain prenatal care and give birth to healthier infants, and less likely to smoke and drink during pregnancy.<sup>6</sup>

**Increasing children's work effort and earnings as adults.** Improving children's educational outcomes improves their future employment outcomes. Researchers reviewing experimental studies estimate that raising a poor family's income by \$3,000 a year (a fairly typical amount for a family to receive from the EITC) between a child's prenatal year and fifth birthday is associated with a 17 percent increase in earnings in adulthood, and an additional 135 hours of work per year, compared to similar children whose families do not receive this increase in income.<sup>7</sup>

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<sup>4</sup> Duncan and Magnuson, "The Long Reach of Early Childhood Poverty," Winter 2011, which is based on an analysis of studies, including those cited here, of the impact of early-childhood poverty.

<sup>5</sup> Chetty, Friedman, and Rockoff 2011.

<sup>6</sup> Kevin Baker, "Do Cash Transfer Programs Improve Infant Health: Evidence from the 1993 Expansion of the Earned Income Tax Credit," University of Notre Dame mimeo, 2008, [http://economics.nd.edu/assets/24011/baker\\_paper.pdf](http://economics.nd.edu/assets/24011/baker_paper.pdf);

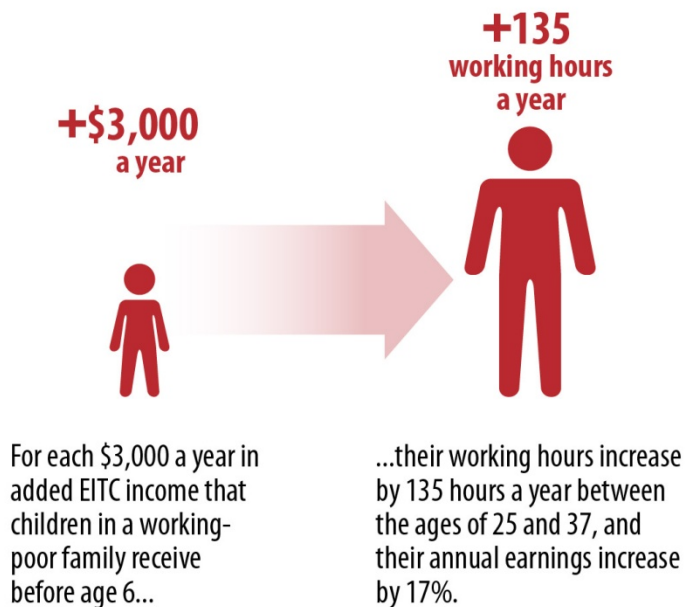
Kate W. Strully, David H. Rehkopf, and Ziming Xuan, "Effects of Prenatal Poverty on Infant Health: State Earned Income Tax Credits and Birth Weight," *American Sociological Review* (August 2010), 1–29, <http://www.irp.wisc.edu/newsevents/workshops/2011/participants/papers/15-Strully.pdf>; William N. Evans and Craig Garthwaite, "Giving Mom a Break: The Impact of Higher EITC Payments on Maternal Health," May 2011, [http://www.kellogg.northwestern.edu/faculty/garthwaite/htm/EITC\\_Health\\_Final\\_Draft.pdf](http://www.kellogg.northwestern.edu/faculty/garthwaite/htm/EITC_Health_Final_Draft.pdf); Hilary W. Hoynes, Douglas L. Miller, and David Simon, "Income, The Earned Income Tax Credit, and Infant Health," NBER Working Paper No. 18206, July 2012, <http://www.nber.org/papers/w18206>.

<sup>7</sup> The \$3,000 figure is in 2005 dollars, equivalent to approximately \$3,530 in 2012. Greg J. Duncan, Kathleen M. Ziol-Guest, and Ariel Kalil, "Early-Childhood Poverty and Adult Attainment, Behavior, and Health," *Child Development*, (January/February 2010), pp. 306-325.

Figure 2

### EITC Income for Poor Children Linked to More Work Hours and Higher Earnings Later in Life

The change in annual adult work hours associated with a sustained \$3,000 increase in income to children in working-poor families before age 6.

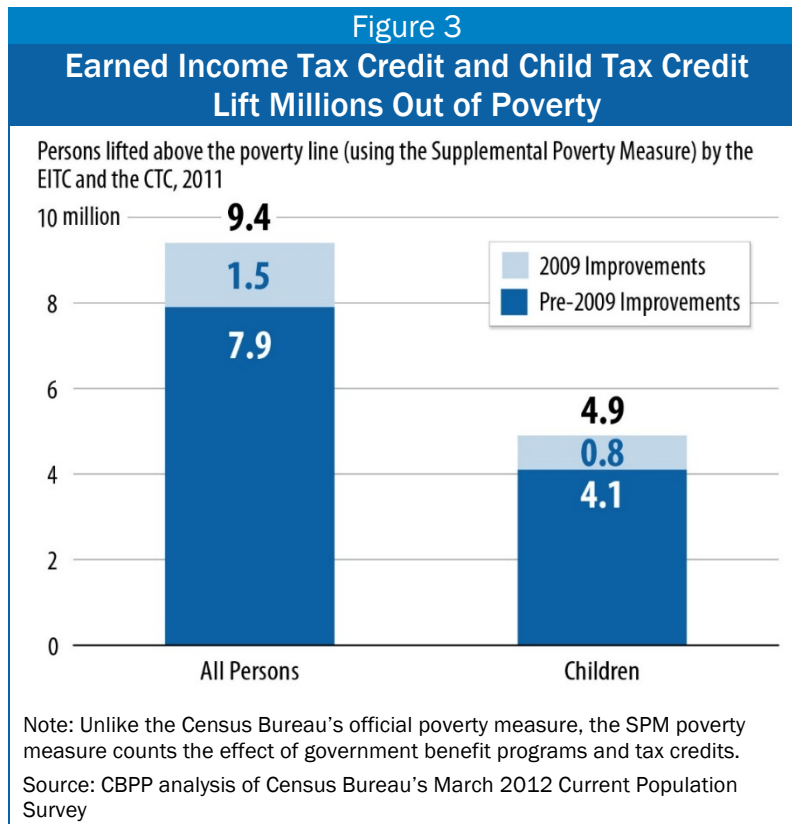


Source: Source: Greg J. Duncan, Kathleen M. Ziol-Guest, and Ariel Kalil, "Early-Childhood Poverty and Adult Attainment, Behavior, and Health," *Child Development*, January/February 2010, pp. 306-325

**Reducing poverty.** The EITC and the CTC lifted 9.4 million people — including 4.9 million children — above the poverty line in 2011, based on the Census Bureau's Supplemental Poverty Measure, a broad measure of poverty that counts refundable tax credit payments as income (and subtracts income and payroll taxes).<sup>8</sup> The improvements to these credits enacted in 2009 lifted an estimated 1.5 million of those people above the poverty line.<sup>9</sup>

<sup>8</sup> The Supplemental Poverty Measure is based largely on the 1995 National Academy of Sciences recommendations for poverty measurement, with amendments reflecting more recent research and the recommendations of the Interagency Technical Working Group on Developing a Supplemental Poverty Measure. For a detailed description of the SPM, see Kathleen Short, "The Research Supplemental Poverty Measure: 2011," United States Census Bureau, November 2012, [http://www.census.gov/hhes/povmeas/methodology/supplemental/research/Short\\_ResearchSPM2011.pdf](http://www.census.gov/hhes/povmeas/methodology/supplemental/research/Short_ResearchSPM2011.pdf)

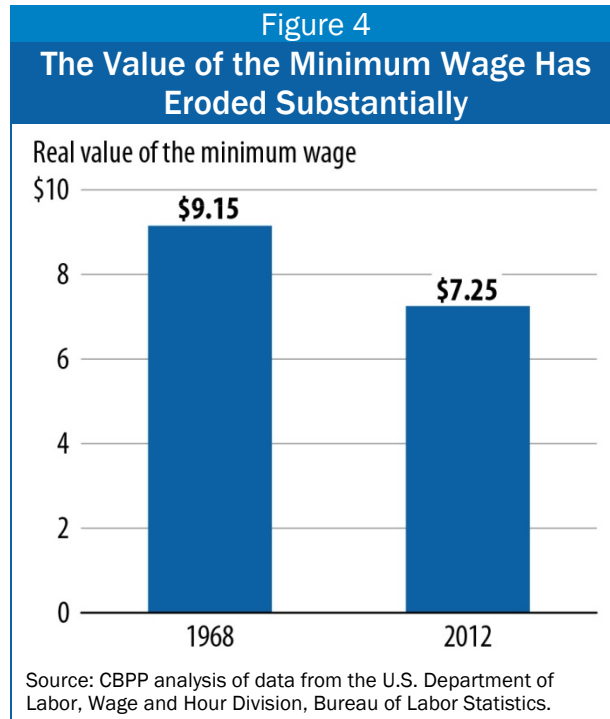
<sup>9</sup> The improvements enacted in 2009 were extended at the start of 2013. They are now scheduled to expire at the end of 2017.



**Supporting low-wage workers.** The minimum wage has eroded substantially, with the real value of the minimum wage falling 21 percent since its peak value in 1968,<sup>10</sup> and the share of good jobs appears to be disappearing for lower educated workers.<sup>11</sup> These trends underscore the importance of the EITC and CTC as policies that partially offset the decline in the real minimum wage and boost the after-tax income of lower-skilled workers.

<sup>10</sup> CBPP analysis of data from the U.S. Department of Labor, Wage and Hour Division, Bureau of Labor Statistics (<http://www.dol.gov/whd/minwage/chart.htm>).

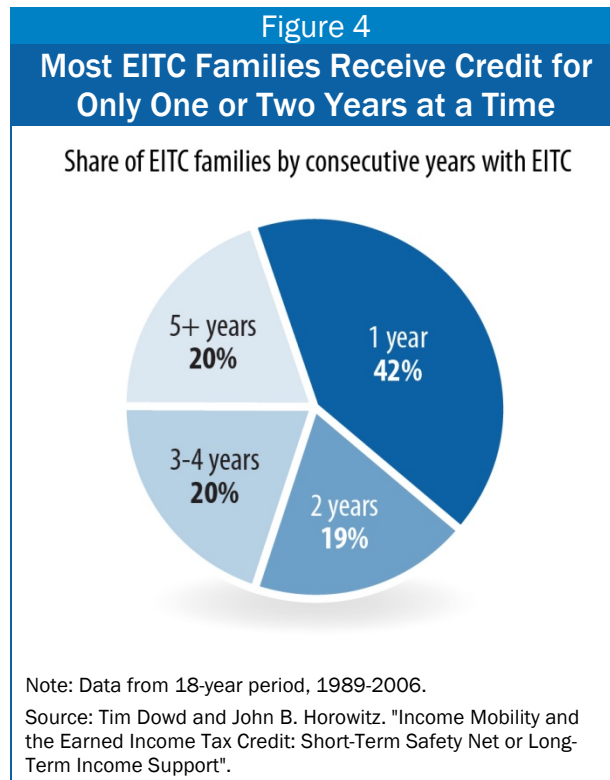
<sup>11</sup> Urban Institute economist Harry Holzer and coauthors from the National Science Foundation, the University of Chicago, and the U.S. Treasury Department concluded that over the long term, “good jobs are not disappearing for everyone, but . . . they are largely disappearing for less-educated workers.” Harry J. Holzer, Julia I. Lane, David B. Rosenblum, and Fredrik Andersson, *Where are All the Good Jobs Going?* (New York: Russell Sage Foundation, 2011), p. 17.



**Providing a short-term safety net.** Most EITC recipients claim the credit only temporarily, when a job disruption or other significant event reduces their income. A recent study covering an 18-year period found that 61 percent of EITC recipients received the credit for only one or two years at a time.<sup>12</sup> A forthcoming study finds that over time, EITC recipients as a whole pay more in federal income taxes than they receive in EITC benefits.<sup>13</sup>

<sup>12</sup> Tim Dowd and John B. Horowitz, “Income Mobility and the Earned Income Tax Credit: Short-Term Safety Net or Long-Term Income Support,” *Public Finance Review* (September 2011), pp. 619-652.

<sup>13</sup> Communications with Tim Dowd of the Joint Committee on Taxation and John B. Horowitz of Ball State.



## Proposals

The Earned Income Tax Credit and Child Tax Credit represent major pro-work and anti-poverty policy achievements. Unfinished policy work remains, however. The 2009 improvements to the EITC and CTC should be made permanent; the credit for workers without children should be strengthened, in part to help address low labor force participation rates among childless adults (particularly men); and proposals that simplify the credits and provide IRS with the authority it needs to tamp down on unqualified tax preparers should be adopted to reduce error rates.

Each is explained in more detail below. Note that while it is important to move forward, it is essential that any tax reform process not compromise the existing success of the EITC and CTC. This is why both the Bowles-Simpson deficit-reduction plan and the Senate's "Gang of Six" plan called for protecting these credits from cuts. Any tax reform process should provide the same protection.

### *Making the 2009 Improvements Permanent*

The 2009 improvements reduced marriage penalties by increasing the amount of income that married couples can earn and remain eligible for the EITC; expanded the EITC for families with three or more children; and increased the support the Child Tax Credit provides to working-poor families by lowering the minimum earnings requirement. These improvements substantially increased the anti-poverty effects of the EITC and CTC. As shown in Figure 3, of the 9.4 million

people lifted out of poverty by the refundable credits, 1.5 million (including 800,000 children) were lifted out of poverty by the these provisions.

If the EITC improvements are not made permanent, substantial numbers of low-income married couples will face larger marriage penalties, and many families, particularly those with three or more children, will fall into, or deeper into, poverty. Altogether, Citizens for Tax Justice (CTJ) estimated that about 6.5 million working families, including 15.9 million children, would have lost some or all of their EITC in 2013 if the 2009 EITC improvements were not in place for 2013.<sup>14</sup>

If the improvements are not extended, working-poor families will be ineligible for the CTC unless their earnings surpass about \$14,700, starting in 2018 (the equivalent of \$13,400 in 2013). A single mother with two children working full-time, year-round at the minimum wage of \$7.25 an hour — and earning \$14,500 per year — will receive a \$1,725 Child Tax Credit in 2018 if the CTC improvement is made permanent. But if the improvement expires, she will receive nothing, since the minimum earnings threshold for the child tax credit will be about \$200 above her earnings. Failure to extend the improvement would also cut the CTC substantially for low-income families with earnings modestly above the \$14,700 threshold. If the CTC improvements had not been extended for 2013, CTJ projects that approximately 8.9 million working families, including 16.4 million children, would have lost some or all of their CTC in 2013.<sup>15</sup>

## **Strengthen the EITC for Childless Workers**

Although substantial progress has been made in recent years to make work pay for families with children, the current EITC suffers from a glaring gap: low income working people who are not raising minor children receive little or nothing. The proven pro-work aspects of the EITC are not available for young people just starting out, including low-income young men, a group with disturbingly low labor-force participation.

Childless workers under the age of 25 are currently ineligible for the childless workers' EITC. For eligible workers between the ages of 25 and 64, the average credit is \$270, compared to an average credit of \$2,790 for tax filers with children. The credit phases in at a rate of 7.65 cents on the dollar for the first \$6,370 of earnings, then quickly phases out at the same rate, beginning at \$7,970 — when earnings are equivalent to just 55 percent of full-time minimum wage earnings.

Childless workers are the lone group that is taxed deeper into poverty by the federal tax system. Under current law, a childless adult working full time at the minimum wage (\$14,500) receives no EITC. Such an individual has a federal income and payroll tax burden of \$2,669 in 2013.<sup>16</sup> A single childless adult with wages equal to the Census poverty line (\$11,905 in 2013) faces a federal tax burden of \$1,826 (including the employer share of the payroll tax).

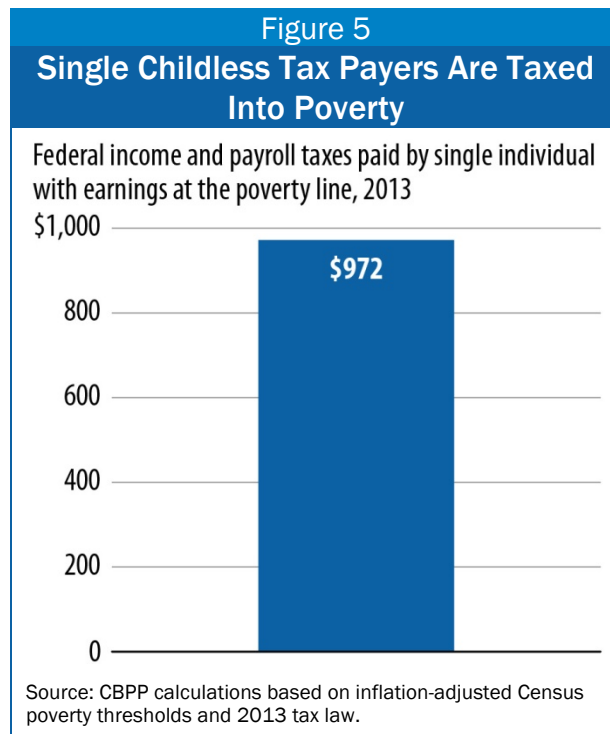
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<sup>14</sup> Citizens for Tax Justice, "The Debate over Tax Cuts: It's Not Just About the Rich," July 19, 2012, <http://ctj.org/pdf/refundablecredits2012.pdf>.

<sup>15</sup> Citizens for Tax Justice 2012.

<sup>16</sup> This figure includes both the employer and employee shares of payroll tax.





Providing a more adequate EITC to low-income workers who aren't raising minor children has several behavioral benefits beyond raising these workers' incomes. Karl Scholz, an economist and formerly Treasury official who is one of the nation's foremost EITC experts, recommends a more generous EITC for young childless workers as one policy to raise their employment rate, writing: "increasing the return to work for childless workers will lower unemployment rates and achieve the dual social benefits of reducing incarceration rates and increasing marriage rates."<sup>17</sup> Increasing the childless worker's EITC will also help boost the income from work received by formerly incarcerated individuals who often face an inhospitable labor market upon re-entry.

The primary design parameters include:

- Eligibility age.
- Phase-in and phase-out rates.
- The level of income at which the phase-in ends (i.e. kink point #1) and the level of income at which the phase-out begins (i.e. kink point #2).
- The maximum benefit (equal to the phase-in rate multiplied by kink point #1).

We recommend lowering the eligibility age to 21, increasing the phase-in and phase-out rates to 15.3 percent, and moving the first kink point to \$8,820 in 2014, raising the maximum credit to about \$1,350. We discuss each in turn:

### Age of Eligibility

<sup>17</sup> John Karl Scholz, "Employment-Based Tax Credits for Low-Skilled Workers," The Hamilton Project, December 2007, [http://www.hamiltonproject.org/papers/employment-based\\_tax\\_credits\\_for\\_low-skilled\\_workers/](http://www.hamiltonproject.org/papers/employment-based_tax_credits_for_low-skilled_workers/)

Currently, workers under age 25 are ineligible for the childless workers' EITC. We recommend that this age floor be lowered to 21, with a student-related exception as discussed below.

Less educated young people, particularly African American men, face a myriad of challenges, including:

- *Low and falling labor force participation rates.* In 2012, the labor participation rate of men aged 20 to 24 was 13.7 percentage points lower than the labor participation rate for men aged 25 to 54. Not only is the labor participation rate of young men low, but it has fallen and continues to fall. From 2001 to 2011, the labor-force participation rate of men aged 20 to 24 fell 6.8 percentage points, while the labor force participation rate of men aged 25 and 54 fell by 2.6 percentage points. Since 2009, the difference between the labor-force participation rates of prime-aged men (25-54) and younger men (20-24) has exceeded its previous historical peak in 1968.
- *Higher involvement in the criminal justice system.* The above figures *understate* the decline in employment among young men, since these numbers only consider the civilian population. Young men disproportionately interact with the criminal justice system, relative to their older peers. According to a recent Justice Department report, 18 percent of men between the ages of 20 and 24 were arrested in 2009. This percentage has increased since the 1980s.<sup>18</sup>

Congress placed the eligibility age at 25 when establishing the EITC for childless workers in 1993 to avoid giving large numbers of students from middle-class families access to the EITC. But as a result, many low-income workers who are *not* students are denied the EITC, and the opportunity to influence employment decisions at the start of the careers of low-income individuals who are not attending college (or are doing so part-time while they work) is lost.

Moreover, at the time that the childless workers' EITC created in 1993, there was no ready way to identify students, who are likely to depend primarily on their parents for support. In 1998, however, Form 1098-T was created to allow taxpayers and the IRS to verify eligibility for the Hope Scholarship and Lifetime Learning credits. This form could be used to identify low-income workers under age 25 who are students at least half time, enabling the EITC to be targeted to low-wage workers who are not students at least half time.

We recommend that the age floor be lowered to 21, with the exception that childless workers between the ages of 21 and 24 who are full-time students would remain ineligible.

### **Phase-in and Phase-out Rates**

As discussed above, the current EITC for childless workers phases in at just 7.65 percent (and phases out at the same rate). This means that it offsets just half of an eligible person's payroll tax burden. This is why a number of previous proposals — including proposals from former Senator John Kerry and Rep. Charles Rangel — would have doubled the phase-in rate for the childless workers' EITC to 15.3 percent. We strongly recommend raising the credit rate to 15.3 percent to

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<sup>18</sup> Howard N. Snyder, "Arrest in the United States, 1980-2009," Bureau of Justice Statistics, Department of Justice, September 22, 2011, <http://www.bjs.gov/content/pub/pdf/aus8009.pdf>

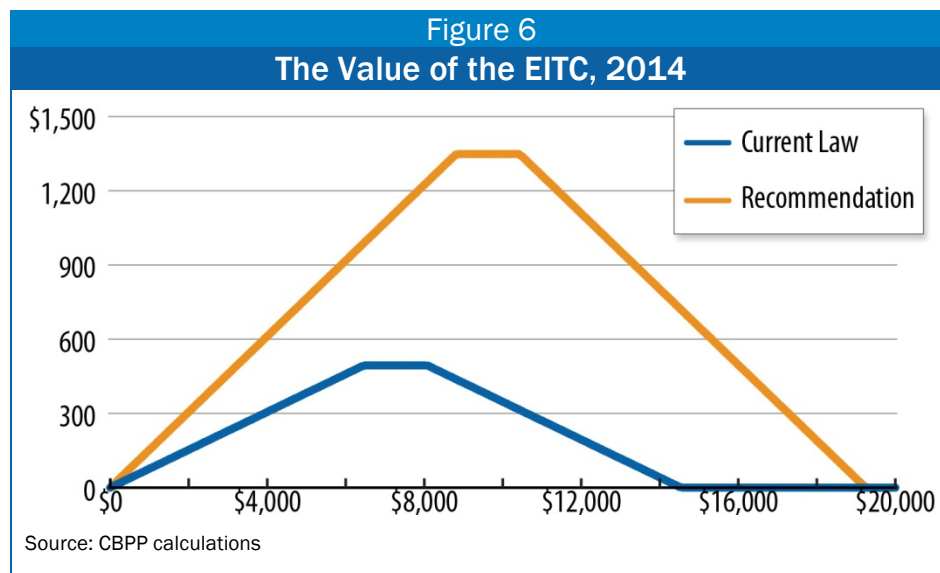
offset payroll tax burdens fully and, in particular, to make the credit larger so that it has a more powerful effect in inducing people to enter the work force (as well as in reducing the extent to which single workers are taxed into, or deeper into, poverty). We also suggest raising the phase-out rate (for budget reasons) also to the same 15.3 percent.

## Kink Points

The first kink point is the level of earnings at which the phase-in ends. The first kink point times the phase-in rate determines the maximum credit. For example, under current law, the first kink point in 2014 would be \$6,460. The second kink point is the income level at which the credit begins to phase-out. It represents the highest income amount at which an eligible person receives the maximum credit. All eligible people earning amounts between the kink points — commonly referred to as the “plateau” — receive the maximum credit. Beyond the plateau (i.e. beyond the second kink point), people receive a smaller credit and eventually no credit.

The phase-out rate is how quickly the credit is reduced for people earning more than the second kink point. In an ideal world, the credit would not phase out. Such a design would reduce adverse marginal tax rate effects and potential unfavorable work disincentives. This feature, however, would be prohibitively expensive. Moreover, given that the most powerful labor participation effects are around the “to work” vs. “not to work” decision, it is more important to focus budget resources on the phase-in and maximum credit than on the phase-out.

We recommend putting a priority on raising the first kink point. Specifically, we propose to raise it to \$8,820 in 2014 — raising the maximum credit to about \$1,350. For the second kink point, we suggest simply keeping the length of the plateau the same as it is under current law, which would put it at \$10,425 in 2014.



<b>Table 1: Options for Expanding the EITC for Childless Workers in 2014</b>		
<b>Parameters</b>	<b>Current Law</b>	<b>Recommendation</b>
Earned Income Base Amount	\$6,460	\$8,820
Credit Percentage	7.65%	15.30%
Max Credit	\$494	\$1,350
Begin Phaseout	\$8,080	\$10,425
Phaseout Percentage	7.65%	15.30%
End Phaseout	\$14,540	\$19,245
Rough 10-year costs (in billions)		\$76
Note: Our rough estimate of the 10-year costs of the EITC under current law is \$17 billion		

<b>Table 2: Value of the EITC for Single Childless Individuals, 2014</b>			
<b>Income</b>	<b>Notes</b>	<b>Current Law</b>	<b>Recommendation</b>
\$7,250	At current minimum wage, 1,000 hours of work a year (part-time)	\$494	\$1,109
\$12,127	Poverty Line	\$185	\$1,089
\$13,224	At 1,500 hours of work per year at a \$9 minimum wage in 2015* (3/4 of full-time)	\$101	\$921
\$14,500	2,000 hours (full-time) of work at current minimum wage (\$7.25/hour)	\$3	\$726
\$17,632	2,000 hours of work per year (full-time) at a \$9 minimum wage in 2015*	\$0	\$247
Note: A \$9 2015 minimum wage is \$8.82 in 2014 dollars			

## Simplification and Improving Compliance

In addition to making the recently extended improvements permanent and strengthening the EITC for workers who are not raising children, we also recommend adopting a series of simplification and compliance measures to reduce errors, including errors made by tax preparers who are not properly trained. Most of these simplification measures were proposed by George W. Bush's Treasury Department and included in several Bush budgets.

Simplification is central to any strategy to shrink EITC errors. Treasury analysts have estimated that the number of tax returns either claiming the EITC in error or claiming too large an EITC fell by approximately 13 percent following implementation of a package of EITC simplification measures enacted in 2001.<sup>19</sup> Treasury followed that up by proposing additional simplifications to the

<sup>19</sup> U.S. Department of the Treasury, "Performance and Accountability Report, Fiscal Year 2009," App. B, p. 219.

EITC to reduce errors; these simplifications were included in several of President Bush's budgets between 2004 and 2008. Congress did not act on these proposals, but they continue to have strong merit. These proposals, which we highly recommend (and which have a modest cost), include the following:

- *Simplifying the rule governing how parents who are separated can claim the EITC.* Normally, married couples must file joint returns to claim the EITC, but for obvious reasons, separated parents often file their own returns. In such a case, a complex rule governs whether the custodial parent may claim the EITC if she files a separate return. For her to do so, she and her spouse must have lived apart for more than six months of the tax year, and she must have lived with the qualifying child for more than six months of the year; this part of the rule is straightforward. But she also must be able to claim head-of-household filing status, and to do so, a parent must meet IRS' "household maintenance" test. This test is very complicated, hard to apply, and poorly understood.<sup>20</sup> As a result, numerous errors result, with low-income working mothers who are separated but not yet divorced mistakenly claiming head-of-household status and the EITC.

Because low-income parents who separate may take a long time to obtain divorces (or court decrees of separate maintenance) — especially if they have difficulty affording the legal expenses — such errors can continue for a number of years. The proposal that the Bush Administration advanced would simplify these requirements by permitting a separated parent who lives with her qualifying child for more than six months of the year — and lives apart from her spouse for at least the final six months of the year — to claim the EITC without having to meet the complex head-of-household filing test. The National Taxpayer Advocate recently made a recommendation to Congress<sup>21</sup> that builds on and improves upon the earlier Treasury proposal, by also removing the head-of-household test when married couples are (1) living apart on the last day of the tax year and (2) have negotiated a written, legally binding separation agreement by the end of that year. In other words, the custodial parent would be able to file as unmarried and claim the EITC, if otherwise eligible, if the other spouse were absent from the home for the last six months of the year *or* if the couple were living apart and had a legal separation agreement by the end of the year.

(A separation agreement is used to divide any property and debts that either spouse has incurred, as well as provide for custody, visitation, and support of any minor children of the relationship. Separation agreements are used by separated couples looking to settle property and custody prior to a divorce judgment. The agreement is accomplished outside of court. Properly drawn and notarized, it is considered legally binding. It does not entail the expense of going to court to reach agreement on these matters and obtaining a divorce, which couples may be unable to afford and may delay for considerable periods.)

This simplification should lead to a significant reduction in EITC errors.

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<sup>20</sup> Among other things, the household maintenance test requires filers to show that they pay more than half of household expenses from their own income and requires them not to count child support payments and public program benefits as part of that income even though such payments or benefits are commonly used for household expenses.

<sup>21</sup> Taxpayer Advocate Service, "2012 Annual Report to Congress, Vol. I," pp. 513-520

- *Allowing filers who live with a qualifying child but do not claim the child for any tax benefit to claim the smaller EITC for workers not raising a child.* Sometimes either of two adults who live in the same household with a child may qualify to claim the child for the EITC. This can occur, for example, when a mother, aunt, and child live together; the aunt may be eligible to claim the child for the EITC if the mother does not. If the mother does claim the EITC for the child, however, current rules *prohibit* the aunt from claiming the smaller EITC for very poor workers who are not raising a minor child even if she otherwise qualifies. The Bush Treasury proposal would address this inequity by removing the disqualification that applies to the aunt in such a case. This proposal would reduce errors; under current rules, the aunt may mistakenly assume she can claim the EITC for childless workers, since she is not claiming a qualifying child for the EITC. If she claims the childless workers' EITC, however, an error is said to occur.
- *Eliminating the EITC investment income test.* Under current law, low-income filers are ineligible for the EITC if they have investment income such as interest, dividends, capital gains, rent or royalties that exceeds \$3,300 a year (in 2013). Very few EITC claimants have investment income above this level. However, EITC claimants in general must navigate their way through complex instructions to determine whether they have income that would be defined as investment income for EITC purposes. The 14-line IRS worksheet necessary to meet this requirement refers to ten separate lines on Form 1040 and to four separate schedules.

The investment income test also creates a “cliff,” since a worker with investment income of \$3,300 is eligible to claim the full EITC while a worker with investment income of \$3,301 is unable to claim any EITC. In addition, the test discourages savings among low- and moderate-income families. Although not as crucial as the two aforementioned simplifications, Treasury earlier proposed to remove this test, which would simplify tax filing and reduce errors.

Finally, we recommend that the Congress, if needed as discussed below, pass legislation to ensure that the IRS's commercial tax preparer initiative moves forward:

*IRS regulation of commercial tax preparers.* Two years into IRS implementation of a new initiative to regulate commercial tax preparers, a January 2013 decision by the U.S. District Court of the District of Columbia has shackled this important tax compliance effort by ruling that IRS does not have statutory authority for the regulatory mechanism it developed. Several hundred thousand commercial preparers, most previously under no requirements of competency to file tax returns on behalf of taxpayers, had already been brought in under the requirement to obtain Preparer Tax Identification Numbers (PTINs) in order to be permitted to prepare and file tax returns for individual taxpayers. Further requirements for these preparers to pass a tax law competency test and certify completion of continuing education courses to update tax law knowledge were phasing in, to take full effect for the 2014 tax filing season.

The IRS has served notice of its intent to appeal the District Court decision. However, if the IRS is unsuccessful upon appeal, it is important that Congress pass legislation authorizing the regulatory approach adopted by the IRS. This effort is a cornerstone of IRS tax compliance efforts. It is particularly vital to efforts to control EITC and CTC overpayments, since a large majority of tax credit claims are filed by commercial preparers, most of whom do not fall under CPA or Enrolled Agent requirements to demonstrate competency. Investigations by GAO and TIGTA have earlier documented commercial preparer ignorance or deliberate flouting of eligibility rules for refundable credits. The regulations, proposed by IRS in 2009, met with broad approval from tax professional

organizations, low-income taxpayer advocates and within the tax preparation community. As IRS stated when announcing the new approach in 2009, "...registration will make it easier for the IRS to locate and review the returns prepared by a tax return preparer when instances of misconduct are detected."<sup>22</sup>

The regulations developed by the IRS closely follow recommendations that have been made by the National Taxpayer Advocate consistently since 2002, and which previously passed the Senate in 2004 as part of the Tax Administration Good Government Act.<sup>23</sup>

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<sup>22</sup> Internal Revenue Service, "Return Preparer Review," December 2009, p. 33, [www.irs.gov/pub/irs-pdf/p4832.pdf](http://www.irs.gov/pub/irs-pdf/p4832.pdf)

<sup>23</sup> National Taxpayer Advocate, "FY 2002 Report to Congress," [www.irs.gov/pub/irs-utl/arc2002\\_section\\_one.pdf](http://www.irs.gov/pub/irs-utl/arc2002_section_one.pdf), pp 69-73 and "2003 Annual Report to Congress," p. 270, [www.irs.gov/pub/irs-utl/nta\\_2003\\_annual\\_update\\_mcw\\_1-15-042.pdf](http://www.irs.gov/pub/irs-utl/nta_2003_annual_update_mcw_1-15-042.pdf)